MANUFACTURING & DISTRIBUTION M&A QUARTERLY

Q4 2022

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MANUFACTURING & DISTRIBUTION M&A QUARTERLY: Q4 2022

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As 2022 wound down and businesses began preparing for the new year, Manufacturing and Distribution (M&D) deal volume and investment activity repeated that of the prior three quarters. Due to rising interest rates, inflation, the labor shortage, and supply chain disruptions that slowed the overall transaction activity in 2022 compared to recent years, the year ended with 3,752 deals closed totaling a value of $241.6 billion. These results were not dissimilar from 2019, pre-COVID where we saw 4,360 deals close totaling a value of $246.5 billion, as well as similar levels in 2013 and 2014 as noted below

Capital invested in the M&D sector during the quarter totaled $42.85 billion with 679 deals closed (compared to 1,357 deals and about $100.9 billion during Q4 of 2021). Both deal count and capital invested in M&D declined steadily throughout 2022 due to several economic and financial factors and uncertainties that may have kept both private equity (PE), and mergers and acquisitions (M&A) investors on the sidelines.

Average M&D deal size decreased slightly during the final quarter of the year to about $63 million, versus $66 million during Q3 and $43 million in Q2. Three very large deals dominated the M&D sector during the final quarter of the year:

- $11 billion acquisition of DuPont's Mobility and Materials business
- $7.1 billion acquisition of Tenneco by Apollo Global Management
- $6.7 billion sale of BellRock Brands to West 4th Holdings

With no new tax regulations or other micro or macro drivers pushing investors to close deals during Q4, activity remained otherwise slow for the sector. The last two years have been somewhat of a roller coaster for investors across most industry sectors as debt remained inexpensive, capital was readily available, and numerous sellers were ready to cash-out.

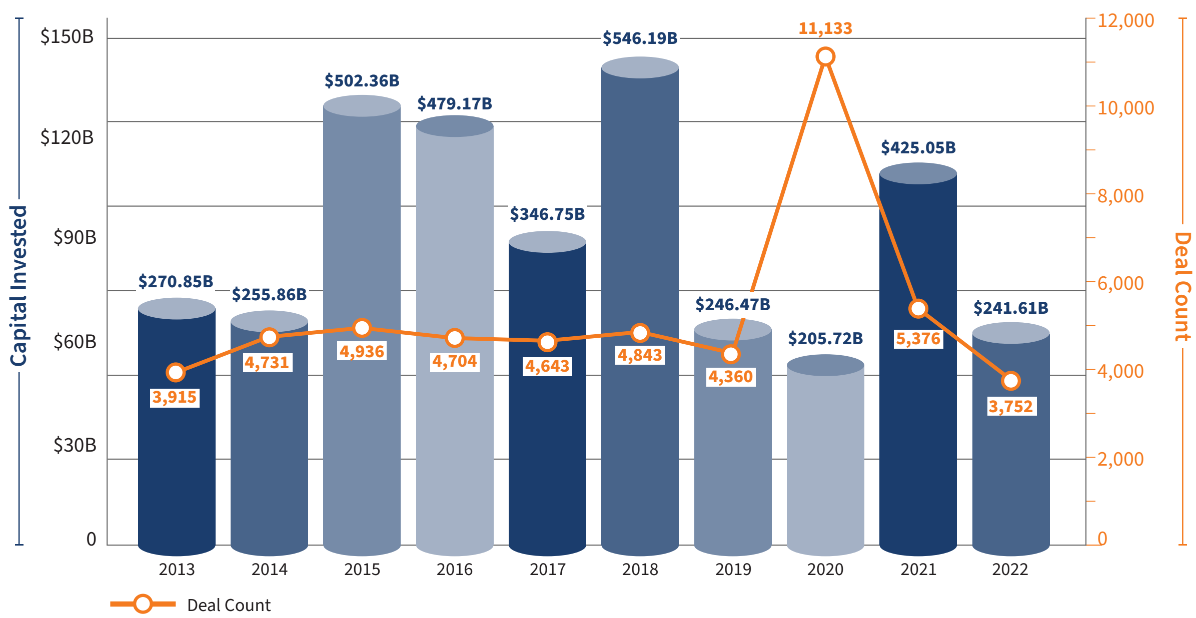
SKIP TO A SECTION:

- 10 year review
- Market factors impacting the deal space
- What's next?
- Generating efficiencies and creating cost saving opportunities for manufacturing businesses
- Food manufacturing deals

10 YEAR REVIEW

All data gathered from PitchBook Data, Inc., as of Jan. 3, 2023

Capital invested by deal count



Bain Capital • Walden International • Advent International
Kohlberg Kravis Roberts • Warburg Pincus

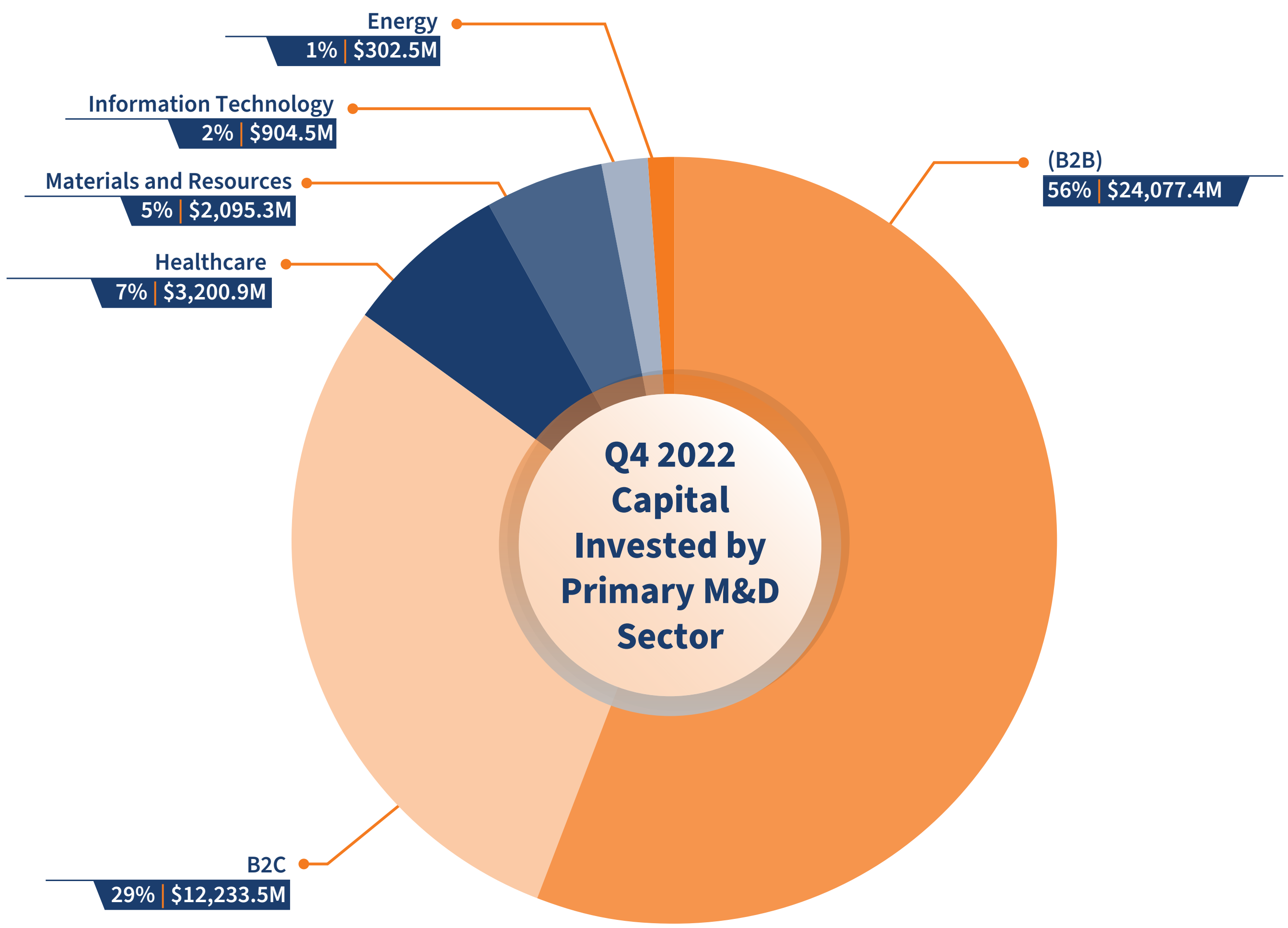
It's important to note that the average deal size during Q4 was consistent with what we've seen over the last two years for the sector. However, if excluding the three very large deals that closed during the quarter – DuPont, Tenneco, and BellRock Brands – the average deal size for M&D was significantly smaller during Q4 at $26.7 million. For example, the average deal size during Q4 of 2021 was $74.3 million and $54.7 million in Q4 of 2020.

In Q4 of 2022, the top investors included Bain Capital, Walden International, Advent International, Kohlberg Kravis Roberts, Warburg Pincus, AEA Investors, Arcline Investment Management, Ares Management, Clayton Dublier & Rice, and Greenbriar Equity Group.

Within the top 10, newer entrants like Walden International, Warburg Pincus, Clayton Dublier & Rice, and Greenbriar Equity Group were involved with multiple, smaller-sized deals.

It's no surprise that B2B continues to lead in M&D transactions and we expect this trend to continue throughout 2023. In Q4, 56% of all M&D deals involved B2B companies compared to 44% during Q4 2021. Concurrently, B2C operations are managing the uncertainty in consumer spending as inflation has driven many consumers to shift purchasing from want to need, specifically for housing and food.

Q4 2022 capital invested by primary M&D sector



MARKET FACTORS IMPACTING THE DEAL SPACE

As we moved through 2022, the Manufacturing and Distribution space emerged from an environment that, for the prior two years, was shaped by the pandemic. As it set itself on a route to "normalization," a few key trends impacted the sector. Concurrently, newer issues like inflation and rising interest rates kept investors on the sidelines for much of the year.

During Q4, some of the top market factors that emerged included:

- **Light at the end of the global semiconductor shortage.** By the end of 2022, many large semiconductor makers were reporting inventory surpluses and slowing sales due to issues like declining consumer demand for electronics. The chipmakers had been working to fix the problem, which in 2023 may shift in the other direction and produce a surplus of chips on the global market. If this happens, both manufacturers and distributors may come out the winners, particularly those that suffered under the strain of the protracted chip shortage.
- **Consolidation of the industrial distribution sector.** Several distributors merged to form larger entities during Q4. For example, Pennsylvania-based electrical distributor, Schaedler Yesco Distribution Inc. acquired Ohio-based electrical parts supplier, YESCO Electrical Supply Inc., and Ferguson plc bought Airefco Inc., the latter of which is a distributor of HVAC equipment, parts, and supplies.
- **Labor strains.** Early retirement, "quiet quitting", and the remote work trend have negatively impacted M&D companies that can't operate at full capacity without the right headcount. While automation is being brought in to help augment labor, and improve efficiencies in processes, we're still a long way from solving the current labor shortage. Warehouses and distribution centers, where employee turnover rates hover around 49%, have been hit particularly hard, according to Supply Chain Dive. On the manufacturing front, NAM expects the skills gap to result in over two million unfilled positions by 2030. Attracting young candidates to an industry typically not identified as fresh and exciting has been a challenge for many years. However, the recent layoffs in the technology industry across multiple blue-chip businesses may set the M&D sector up to present itself as a reliable, steady, and long-term career opportunity.

Q4 2022 Top 10 deals

Company Name	Deal Size (millions)	Investors	Deal Type
DuPont (Mobility And Materials Business)	11,000M	Celanese	Merger/Acquisition
Tenneco	7,100M	Apollo Global Management	Buyout/LBO
BellRock Brands	6,663M	West 4th Holdings	Merger/Acquisition
Hanger	1,250M	Patient Square Capital	Buyout/LBO
Minnesota Rubber & Plastics	950M	Trelleborg Group	Merger/Acquisition
Emtek Products	800M	Fortune Brands Home & Security	Merger/Acquisition
Saratoga Food Specialties	588M	Astorg, Solina Group	Buyout/LBO
Metrics Contract Services	480M	Catalent	Merger/Acquisition
Resolute Industrial	440M	Aggreko, Carson Private Capital, I Squared Capital, Oaktree Capital Management, TDR Capital	Buyout/LBO
Corium Pharma Solutions	408M	Gurnet Point Capital, Webster Equity Partners	Buyout/LBO

WHAT'S NEXT?

We are still optimistic about transactions in the Manufacturing and Distribution industry for 2023. A significant amount of capital still remains in the market, ready to be invested, with investment term limits that still need to be met. There are many private equity firms raising new funds and many individuals becoming new investors. While interest rates have risen, they are at levels we have seen before. However, it may require more compromise between the seller and the buyer on valuation and deal structure to close a transaction. The volatility in the markets will remain for a while in 2023, if not through the entire year, and we expect this will drive a continued slower pace of transactions closing as buyers continue to monitor how businesses are performing before signing off on the final agreement. We also expect to see this impact B2C as consumer demand remains unpredictable with inflation and interest rates at their current levels.

As larger companies seek out complementary M&D plays to add to their existing portfolios, more add-ons to established platforms will likely take place. These moves can help the acquiring companies manage supply chain issues, reach customers in new geographies, or otherwise strengthen their existing platforms. While the add-ons will drive down individual deal size, we expect deal numbers to continue to be similar to years prior, including the robust deal count we saw in 2021.

GENERATING EFFICIENCIES AND CREATING COST SAVING OPPORTUNITIES

As organizations across all sectors find ways to do more with less in 2023, both manufacturers and the private equity firms that invest in them will be focused on generating efficiencies and leveraging ongoing cost saving opportunities.

One of the common missteps that manufacturers overlook when it comes to cost accounting and inventory reporting is that they don't capture all the costs associated with an item in inventory. A review of the standard costing practices from ASC 330, for example, states that all costs relating to bringing an inventory to its final destination should be captured. This includes, for example, the cost of procuring, shipping, storing, and maintaining the inventory in the warehouses (plus any other costs incurred during the process).

Indirect costs are also important. We identified for one of our manufacturing clients specific procurement costs that could be capitalized but currently had not been. For best results, both manufacturers and investors should aim for a holistic view of both direct and indirect costs to fully understand exactly what constitutes a cost component that needs to be capitalized.

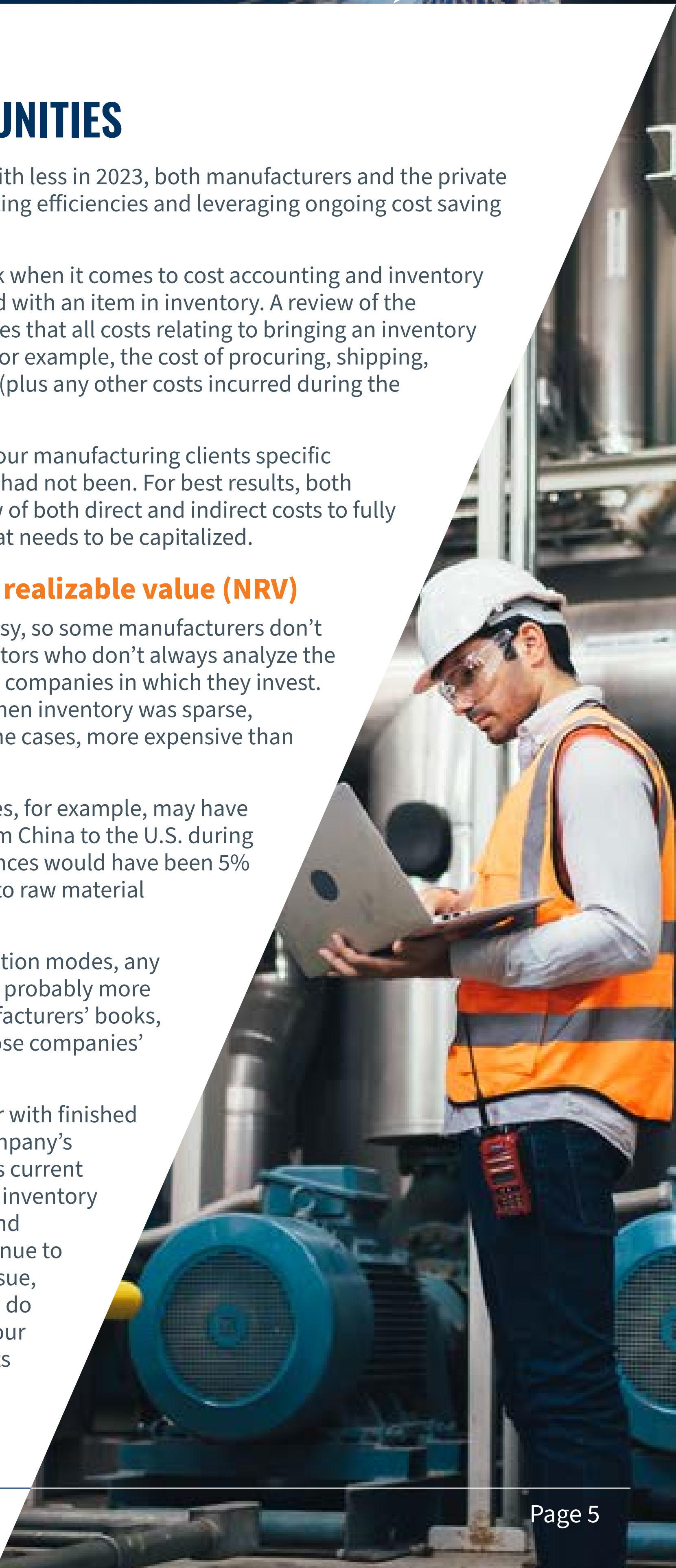
The importance of inventory costing to net realizable value (NRV)

Accounting for every one of these activities isn't always easy, so some manufacturers don't even attempt it. This can create a bigger problem for investors who don't always analyze the net realizable value (NRV) or current "market value" of the companies in which they invest. This became a major issue during the global pandemic, when inventory was sparse, difficult to source (particularly from overseas), and, in some cases, more expensive than ever.

The domestic manufacturer that relied on overseas sources, for example, may have paid astronomical freight rates to get its raw materials from China to the U.S. during the pandemic. Where in the past the inventory costs variances would have been 5% to 10%, today they can reach as high as 50% or more due to raw material price volatility.

While freight rates have leveled off across most transportation modes, any goods that were procured in 2021, or even into 2022, were probably more expensive to ship. These inventories may still be on manufacturers' books, even though prices have since come down. As a result, those companies' costs may be higher than the current marketable value.

If an auditor identifies a lower cost of market issue – either with finished goods or raw materials – for a manufacturer, then that company's inventory may be impaired. That's because the inventory's current value may be higher than its current replacement cost. An inventory impairment ultimately impacts the NRV which investors and manufacturers themselves should be aware of as we continue to experience volatility in the supply chain. To address the issue, manufacturers should ask themselves questions like: How do we track and manage our inventory costs? Do we change our standard costing or do we keep our standard costing assets and figure out a better way to explain these variances?



Key points to keep in mind when building a cost accounting system include:

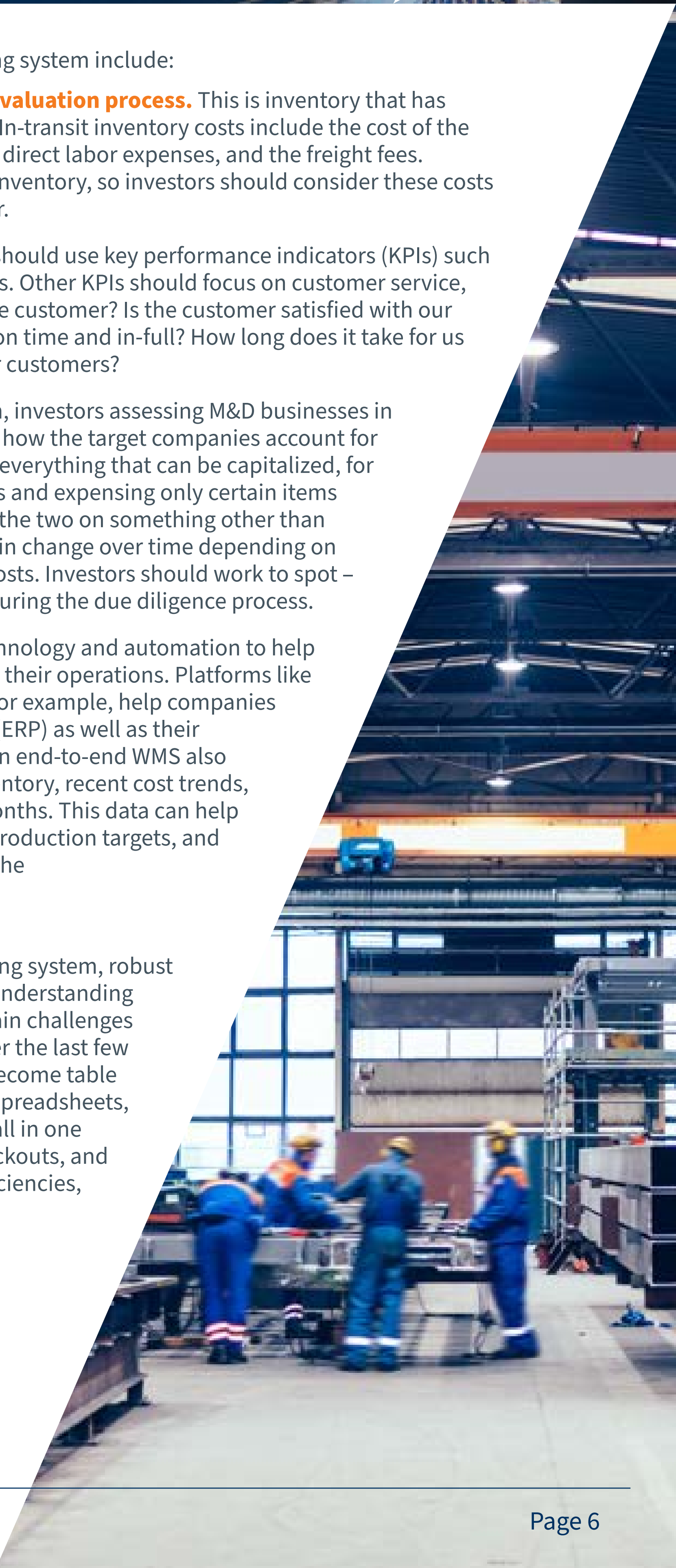
- **In-transit inventory should be incorporated into the valuation process.** This is inventory that has been purchased and is on its way to a final destination. In-transit inventory costs include the cost of the goods themselves, procurement costs, any indirect and direct labor expenses, and the freight fees. Many manufacturers neglect to capture their in-transit inventory, so investors should consider these costs as they analyze businesses in the M&D industry this year.

- **KPIs are important.** At a minimum, all manufacturers should use key performance indicators (KPIs) such as inventory turns, shrinkage, and order fulfillment rates. Other KPIs should focus on customer service, with the key questions being: How are we doing with the customer? Is the customer satisfied with our deliveries? Are we fulfilling orders and delivering them on time and in-full? How long does it take for us to receive the goods and then turn orders around to our customers?

- **Seek out maximum consistency.** In the financial realm, investors assessing M&D businesses in 2023 should seek out maximum consistency in terms of how the target companies account for certain items. If company A is capitalizing anything and everything that can be capitalized, for instance, while company B is in a similar line of business and expensing only certain items that can be capitalized, then you may need to compare the two on something other than performance. One company may experience a 3% margin change over time depending on changes in raw materials, labor, and other capitalized costs. Investors should work to spot – and correct, if possible – the potential inconsistencies during the due diligence process.

- **Put technology to work.** Manufacturers can utilize technology and automation to help them generate efficiencies, save money, and streamline their operations. Platforms like cloud-based warehouse management systems (WMS), for example, help companies understand their existing enterprise resource planning (ERP) as well as their fulfillment, distribution, and supply chain operations. An end-to-end WMS also provides real-time insight into the exact location of inventory, recent cost trends, and how prices have changed over the prior 12 to 24 months. This data can help manufacturers do more accurate forecasting, develop production targets, and project future sales; all of which help companies order the raw materials or goods that they need when they need them.

Whether your company uses a "standard" or "direct" costing system, robust cost accounting allows for better business decisions and understanding of the margin and profit drivers. With the many supply chain challenges that manufacturers and distributors have experienced over the last few years, having real-time insights on a single platform has become table stakes. Rather than needing to refer to different systems, spreadsheets, and emails for this information, smart companies have it all in one place. Robust cost accounting helps avoid overstocks, stockouts, and unhappy customers. It also helps companies generate efficiencies, save money, and add value to their operations.



FOOD MANUFACTURING DEALS

Investment in food manufacturing continued in Q4, albeit at a lighter pace than prior years. The biggest deals of the quarter were:

- Mill Haven Foods' new $160 million in debt financing from a group of six different financers
- The acquisition of Imperial Sugar by United States Sugar for $315 million
- Saratoga Food Specialties' $587.5 million acquisition by Solina Group
- Plant-based food producer AuraPea's round of $335,000 in venture funding

The plant-based food trend appears to be cooling off. These options remain pricier than traditional meat products and may be feeling the impact of lower consumer spending in an inflationary environment. Bloomberg reports that, after enjoying double-digit growth, plant-based sales were down 10.5% for the 12-month period ending Sept. 4, 2022, with saturation in the U.S. market also playing a role in the decline.

Other food manufacturing trends that emerged in the latter half of 2022 and are expected to impact the space during the year ahead include:

- **Vertical farming for better sustainability.** In response to consumers' rising interest in sustainable foods, farmers are "stacking" rows of plants on top of each other as a way to use less land and produce less waste. Large plots of land also continue to be difficult to find in non-remote, distant areas, and/or are very expensive. Vertical farming has become a more feasible option for younger entrepreneurs who wish to take part in farming and technology changes.
- **Vegan seafood for the masses.** While the traditional plant-based burgers and chicken-like options have declined, the plant-based seafood market is expected to reach $1.3 billion by 2031. Good Catch was recently acquired by Wicked Kitchen to further expand its product distribution and portfolio, and the founder of Gardein and Yves Veggie Cuisine introduced the first frozen vegan sushi and onigiri.
- **Cleaner ingredients.** Consumers want to know more about the "healthy foods" that they are consuming and processed brands may be overlooked for those that offer cleaner and truly healthier formulations.

  NIST says consumers who understand their food are demanding more choices that are healthier and processes that are more transparent. They are looking for brands to demonstrate a commitment to reducing their impact on the environment (i.e., "Scan this QR code to see how much water it took to make this bottle of salsa, then tell us how you feel about it").
- **Natural sweeteners.** Sugary sodas and artificially sweetened foods have been linked to cancer, heart disease, and other diseases. Knowing this, consumers are looking for healthier alternatives to sweeteners commonly used in soda. In 2023, look for more food and beverage manufacturers to use natural sweeteners like agave nectar, stevia, dates, and monk fruit.

  In Q4, Imperial Sugar, which provides sugar and specialty sweetener products for consumers, retailers, food service distributors, and food manufacturers, was acquired by United States Sugar for $315 million. The acquisition will allow the latter to better serve its domestic customers.

- **Resource optimization/sustainability.** NIST says the food industry is likely to face increases in regulations pertaining to emissions, resource use, and waste. "Many food companies can make significant improvements in this area by learning how to quantify their waste streams and measure improvements," the government agency says.

Investors are paying attention. In October, Aurora Capital Partners acquired Universal Pure, a provider of cold chain logistics services committed to helping improve the safety, quality, and nutrition of what customers eat and drink. The company offers a range of services including high-pressure processing (HPP), cold storage, kitting and assembly, beverage co-packing, and tempering along with pre-pricing, code dating, netting, and inventory management; thereby helping food, beverage, and pet food manufacturers safely bring improved and cleaner-label products to market.

Company Name	Deal Date
▶Mill Haven Foods	08-Dec-2022
▶Yup Pup	02-Dec-2022
▶Imperial Sugar	30-Nov-2022
▶Saratoga Food Specialties	02-Nov-2022
▶Universal Pure	31-Oct-2022
▶AuraPea	27-Oct-2022
▶Bravo (Manchester)	20-Oct-2022
▶Green's Natural Foods	17-Oct-2022
▶Culinary International	12-Oct-2022
▶Sundays	04-Oct-2022

We are excited to see what 2023 brings as we come back to a more traditional financing market but, this time, with many sellers and investors who are interested in closing transactions. We expect to see smaller deals in the form of add-ons to platform businesses or strategic acquisitions to diversify the current business, as well as opportunistic transactions for businesses that may be distressed and need additional support to return to prosperity.

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